The Rise of Coworking

Corporate tenants are working differently, presenting new opportunities and questions for owners.

Issues addressed in this edition of the Yardi Thought Leadership series:

• Characteristics of leading coworking markets
• Opportunities and strategic options for building owners
• Potential advantages and drawbacks to participating in the niche

A sea change is taking place among corporate space users. They are working differently than ever before, the result of technological advances, a generational shift in the labor pool, and cost.

One of the key developments in this changing environment is the coming of age of shared workspaces. The basic idea has been around since at least the 1980s, but it is a real factor in office markets nationwide.

The forces behind this trend are elemental. For startups, it means ready-made offices without the worry or added expense of long-term leases and major outlays for furniture and equipment. For more established corporate users, shared space offers the flexibility to control footprint growth as business needs demand, such as accommodating special projects or regrouping teams of workers.

Adding to this complex set of issues are new leasing guidelines established by the Financial Accounting Standards Board. Occupants will be required to book the entire term of a lease as a balance sheet liability. That is widely expected to provide incentives for shorter leases, including those offered in shared workspaces.

This surge in popularity for shared space points to a new wave of opportunity, but as with any rapidly changing field, assessing its risks and rewards poses a challenge for owners, managers and advisers.

Flexible workspace inventory is growing 23% a year on average and has increased from 14.7 million square feet in 2011 to nearly 51.2 million square feet in 2017. Source: JLL.
Still relatively young, coworking offers property investors and operators both robust growth and plenty of runway. As JLL recently reported, flexible office inventory has expanded from 14.7 million square feet in 2011 to nearly 51.2 million square feet in 2017. During one recent 24-month stretch, flexible space accounted for 18.1 million square feet of absorption, translating to 29.4 percent of absorption nationwide. Today, independent third-party service providers account for less than 5 percent of U.S. office inventory; by 2030, new evolving workplace practices are expected to boost that share to 30 percent, JLL estimates.

Two other metrics point to continuing nationwide expansion, as well. Emergent Research estimates that the number of spaces will grow from 4,528 spaces in 2018 to 6,219 in 2022, a 9 percent annual increase, and membership will nearly double over the same period, from 638,000 to nearly 1.1 million by 2022.

Drilling down to the metro level, a recent survey of 20 major U.S. markets by Yardi Matrix identified 1,166 coworking sites representing 26.9 million square feet of space. While by no means insignificant, the total represents just 1.2 percent of total office space in those 20 markets.

“Landlords and investors are entering the flexible workspace industry because they see an opportunity to increase occupancy, capitalize on the millennial demographic and get a better foothold in the tech industry,” said Dale Hersowitz, vice president of coworking at Yardi. For owners, coworking spaces provide an incentive to “repurpose and reposition office spaces that were built before 1980, offering services and amenities to attract new tenants,” he explained.

Although the coworking market is by no means limited to millennials, that cohort finds particular appeal in shared space, Hersowitz noted. “The millennial workforce is more transient and entrepreneurial, more occupied with short-term and freelance labor,” he explained. “Because this demographic can’t commit to a larger office space, a flexible model provides a solution where everyone benefits, tenants and owners alike.” Millennials are now the dominant U.S. worker group by a factor of three to one, according to Pew Research.

**Coworking Models**

Not surprisingly, densely populated major markets tend to attract the lion’s share of coworking leases. Manhattan, which tops the list in the Yardi Matrix survey, has 245 coworking locations totaling 7.7 million square feet, while Los Angeles has 158 locations with 3.7 million square feet. Other metros with significant coworking space include Dallas-Fort Worth (1.6 million square feet), Atlanta

![Number U.S. Coworking Spaces](image-url)

*Coworking spaces are expected to increase from 4,528 in 2018 to 6,219 by 2022. Source: Emergent Research.*
Scheduled for 2018 completion, 3675 Market will provide Philadelphia’s largest shared office space. Rendering: ZGF Architects.

model for coworking services. At 3675 Market, a 345,000-square-foot, 14-story building scheduled for completion in 2018, shared workspace is no afterthought, but an essential part of the business plan.

In a bid to attract startups generated by Philadelphia’s medical, scientific and higher education communities, Cambridge Innovation Center (CIC) will make its local debut in a 127,000-square-foot coworking and incubator space that will be the largest in the city. Crucially, 3675 Market’s location boosts its chances to compete successfully. The property will be part of uCity Square, a 6.5 million-square-foot mixed-use community envisioned as a hub for science, education and innovation.

Moreover, the market is still fragmented, another factor appearing to open the door to established owners. Regus and WeWork account for about 60 percent of the market between them, but the coworking field offers the impression that any number can play. Philadelphia provides a case in point. As Cushman & Wakefield notes in a recent market snapshot, no fewer than 17 providers account for 512,000 square feet of coworking space in the city’s central business district.

A project underway in downtown Philadelphia illustrates a large-scale, institutional-caliber approach. A project underway in downtown Philadelphia illustrates a large-scale, institutional-caliber approach.

Emerge212, an affiliate of SL Green, recently unveiled 56,000 square feet of high-end shared space at 1185 Avenue of the Americas, a Midtown Manhattan trophy tower. Photo: SL Green Realty.

(1.5 million) and the San Francisco Bay area (1.5 million). Bringing up the rear in Yardi Matrix’s top 20 are Southern California’s Inland Empire, San Antonio and Fort Lauderdale, Fla.

Meanwhile, some institutional owners are choosing to compete with coworking providers by, in effect, trying to beat them at their own game. Manhattan’s largest office landlord, SL Green Realty Corp., offers a small portfolio of high-quality shared workspace through its Emerge212 affiliate. In November 2017, Emerge212 unveiled its third and most recent coworking facility at 1185 Avenue of the Americas, SL Green’s 1.1 million-square-foot trophy tower in Midtown Manhattan; the shared workspace occupies 56,000 square feet on the second and third floors.

SL Green and Emerge212 are positioning 1185 Avenue of the Americas to match the sophistication and amenities expected of office properties in the area. As Emerge212 Director James Kleeman stated when the space was...
unveiled, “What sets Emerge212 apart is that we seek to define where officing meets design and hospitality."

Suites can accommodate as many as 30 workstations, and offer high-end amenities ranging from noise-canceling sound stations to a floor-to-ceiling moss wall and café areas equipped with charging stations.

**Growth Factors**

Though major markets present opportunities for growth, other factors are associated with the advancement of the niche. As the Yardi Matrix report details, demand for shared space corresponds closely to markets with a strong entrepreneurial presence, particularly in knowledge-based industries. Technology startups may be the most familiar examples, but the potential customer base for coworking varies widely, from new media and telecommunications to life sciences.

Hersowitz cites a 2017 LiquidSpace survey that identifies a crucial link between landlords and the growth of tech companies, noting that technology jobs have increased twice as fast as other office-using jobs. “The growing presence of startup and tech clients has generated some of the most significant job gains over the past decade,” he said. To pass on the opportunity to provide coworking space may be to miss out on a major source of demand and revenue.

Market dynamics, too, influence opportunities for shared space. In metros that offer low barriers to development and relatively high office vacancy, new companies enjoy better odds of finding space that is both affordable and well located. Yardi Matrix cites Houston and Dallas as examples. Miami ranks only seventh overall, however it ranks first for coworking space as a percentage of total inventory (2.7 percent). In second place is Manhattan with 1.7 percent.

Underlying the mid-range and long-term prospects for coworking space are powerful economic currents. The rise of coworking coincides with a steady (if modest) expansion that has lasted for the better part of a decade. As a result, the shared-space model has yet to confront a recession, ”and certainly will be tested the next time the economy hits a bump,” Yardi Matrix predicts. The No. 1 risk for an owner considering offering coworking space will be maintaining revenue when growth slows or reverses, an entrance into a recession.
“The flexibility of short-term leases cuts against the industry,” the report notes. “Tenants value flexibility, but long-term leases protect the landlord. Small businesses and startups are the first to fail during recessions, and entrepreneurial workers that lease coworking space could instead work from home when budgets are squeezed.” When larger corporate clients deem it necessary to tighten their belts, declining to renew short-term coworking leases could be an easy solution.

Embedded in that warning is a challenge to owners and brokers of corporate space as they develop models to match their clients’ new methods of working. That, in turn, puts stress on traditionally structured long-term leases.

Another challenge is the low barrier to entry that makes the business model appealing and has generated a large number of participants. “Competition among the plurality of small players is likely to grow as the industry becomes established, much as a successful new retail model quickly gains imitators,” Yardi Matrix notes. “That could result in a wave of companies combining or failing during a downturn.”

Particularly for owners who opt for a do-it-yourself approach to coworking amenities or branding, scale is an issue. Despite the practice’s gathering momentum, there are some investor concerns “that if coworking comprises more than a third of the rent roll of an asset, the long-term capital value could be negatively impacted,” says CBRE’s Scott Marshall, the firm’s Americas president for advisory and transaction services and investor leasing. In other words, it is possible to have too much of a good thing.

The low barrier to entry will only facilitate this major change in perception. “You don’t need a lot of capital to set up a coworking operation,” observes Paul Fiorilla, associate director of research at Yardi Matrix and author of its recent coworking study. “If owners find a stumbling block to that strategy, it might be the addition of amenities, which may or may not already be available in an owner’s asset. Nevertheless, those amenities are a growing part of the coworking model, which creates a sense of atmosphere, socialization and worker support.”

Scale appears to be a major determinant of whether a coworking space succeeds financially. The tipping point seems to be 50 members; below that threshold, only one quarter of coworking spaces achieve profitability, while above that level, the percentage soars to 51 percent and keeps rising.

Also of note, nine out of 10 privately owned coworking spaces return a profit after two years of operation, according to a report from WUN Systems (acquired by Yardi in October 2017).

Chances of success, of course, are influenced by local demographics. In addition to surveying current tenancy for their on-demand space needs, consider general demographics, including the number of freelancers and workers from home, as well as small businesses in the area, the firm advises in its e-book, The Cost of Coworking. And always remember the power of word-of-mouth in increasing visibility for a coworking provider.

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**Ages of Coworking Spaces When They Broke Even**

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Nine out of 10 privately owned shared office spaces are profitable two years after opening. Source: Deskmag research/”The Cost of Coworking,” a WUN systems e-book.

These are the results of the coworking spaces that made zero profit and zero loss, other coworking spaces were not considered due to a missing filter. Filter questions were used to reduce the number of irrelevant questions for example, a question regarding ‘breaking even’ does not make sense for unprofitable spaces. Thus, such questions were filtered out. Although the complex filter also affected profitable spaces, the results are likely to be similar to other profitable coworking spaces break even. A coworking space that broke even no longer runs at a loss.
Weighing the Options

Owners recognizing the need to incorporate coworking into their portfolios have options to explore. To begin with, it is noteworthy that the nature of a multi-tenant office property lends itself well to a successful coworking model. Steve Weikal, head of industry and alumni relations at the MIT Center for Real Estate, recently told a meeting of the Institute of Real Estate Management that ownership could divide a property into three basic tiers. On levels immediately above the lobby, full or partial floors could be dedicated to incubator space or startups. The next tier up would consist of a few floors for short- and longer-term coworking uses. Higher floors would be reserved for more expensive long-term leases.

That stack starts with entry-level coworking, such as a lobby coffee shop, that typically involves a stay of one to 18 months, notes George Vogelei, a Washington, D.C.-based executive vice president with Transwestern and specialist in representing institutional and private office property owners. After that initial phase, tenants could take one-year to three-year leases in a dedicated coworking setting, followed by a move to owner-controlled spec space. The final step in this pattern would be a 10-year lease on an upper floor.

To balance risks and rewards, Vogelei recommends that owners devote no more than 10 percent of the portfolio’s space to coworking, whatever form it takes. Nevertheless, adds Weikal, some landlords report that coworking license fees generate as much as six times as those for base rent on a master lease.

Vogelei adds that Class B assets serve as well for coworking sites as Class A trophy properties do, if not better. To start with, Class B buildings are likely to be locations of choice for tenants that are just starting out. And, as he observes, “there are only so many law firms and lobbyists to go around.”

Whatever the asset category, the crucial factor for implementing coworking is the appetite for risk. Here are the four basic options, presented in ascending order of risk to the owner:

Option 1: Leave it to the pros. Rent space to a coworking operator and leave the worry to the provider. If that’s the choice, be sure to select a high-quality operator “with the ability to attract and retain users over the long run,” Vogelei advises. “There are a lot of commodity players in this sector.” For this option, which Vogelei himself favors, the owner’s agreement with the coworking provider is a standard lease.

Option 2: Pick a partner. Third-party service providers are another potential path to coworking success. As in Option 1, the service provider handles the responsibilities for day-to-day operations. One difference: The agreement between landlord and service provider can combine a discounted leasing rate with a share of the profit. Alternatively, the provider can earn a fee for the service while the landlord receives the profit. In either case, both parties wait for clients to come in.

Option 3: Go it alone. Low barriers to entry notwithstanding, this is the toughest row to hoe, says Vogelei. This scenario requires the owner to shoulder all the expense and risk while competing with seasoned players in the local market. “Owners aren’t set up for this,” he contends. “They’re better off focusing on their core business.”

Option 4: Sit it out. This choice is no longer realistic for owners who expect to stay competitive. As Vogelei says, “Coworking is here to stay. It’s in its early stages of growth, and will continue expanding.”

Clearly, coworking is a consideration for building owners and asset managers seeking to maintain their competitive edge. If office space is viewed not merely as a product but as a service, shared-space options have a vital place in the portfolio.

That imperative speaks directly to the ROI of any office property. Tenants are already redefining the configuration and performance of the spaces they occupy. Now it is up to owners, managers and advisers to assess the place of shared space in their portfolios, and respond.